ECONOMICS FOCUS

Money rules

In setting interest rates, should a central bank follow a pre-set rule or use its discretion? Many economists seem to say one thing but believe another

WHEN the Federal Reserve decided to cut American interest rates by a quarter of a point on October 15th, it took everybody (including *The Economist*) by surprise. Nothing in its earlier announcements had prepared markets for the move. Economists, by and large, were impressed by the ambush: Alan Greenspan, timing his move to perfection, had shown his mettle once more.

But should they have been so impressed? The academic literature on monetary policy tends to frown on "discretion"—that is, on an approach to setting interest rates that trusts the central bank to weigh lots of evidence, think hard, and arrive at an ad hoc conclusion suited to the particular circumstances. When it comes to monetary policy, economic theory tends to prefer "rules". Rather than ask the central bank to use its judgment, it is better simply to tell it to keep the money supply growing at a certain pre-announced rate, for instance.

The Fed's latest rate cut was discretion in spades. Yet economists mostly cheered. Don't they believe their own theory?

It would be odd not to, because the theory is very plausible. The preference for rules over discretion is based on three main observations. First, using monetary policy to fine-tune economic activity is extremely difficult, because of the long and unpredictable delays between changes in interest rates and their subsequent effects on the economy. Second, in the longer term, changes in monetary policy affect only inflation. In other words, it is impossible through easier monetary policy to run the economy at a permanently higher level of activity and/or lower rate of unemployment. Very few economists would dispute either of these arguments; together they already imply that discretion is unlikely to be successful.

Then comes the clincher: a third, and somewhat subtler, argument. In the short term, with wages fixed for the time being, an increase in demand created by easing monetary policy will indeed raise output and employment. This tempts policymakers to surprise the economy now and then, yielding on each occasion a temporary rise in output. The trouble is, you cannot surprise people very often. Firms and workers will soon get the hang of things. When they come to set wages and prices, they will learn to anticipate the attempted surprises. The result will be no further gains in output, temporary or otherwise, and a persistent bias towards higher inflation. This third argument implies that discretion is not merely ineffective, but systematically damaging.

Target practice

In principle, then, a rule which the markets understand, and which commits the central bank to aim for price stability, offers the great benefit of lower inflation, on average, at no extra cost in terms of forgone output or employment. In practice, though, there is a problem. It is hard to think of any rule that could or should be followed entirely mechanically—that is, entirely without discretion.

Even a rule as "pure" as the pre-1914 gold standard, which committed central banks to maintain the value of the currency at a fixed parity with gold, never quite worked this way. Governments had discretion at the margins. The money-supply rules advocated by modern monetarists also allow some discretion, not least in the choice of monetary target.

Even if such rules could be unambiguously defined, following them rigorously would sometimes carry a cost. Extraordinary circumstances arise from time to time. The best policy in these special circumstances might be looser (or tighter) than the rules dictate. At such times it is implausible, economically and especially politically, to argue that the central bank ought to show no "flexibility".

In reality, then, policymakers are obliged to choose not between the stark alternatives of pure rules and total discretion, but among a range of possibilities in between. "Inflation Targeting", a forthcoming book by Frederic Mishkin, of Columbia University, and others, makes the case for one such middle way—a kind of "constrained discretion". Central banks, it argues, should steer interest rates by reference to an announced inflation target.

This is closer to a pure rule than to pure discretion—though not enough to satisfy a strict monetarist. The authors argue that it combines the main advantages of the pure regimes: like a rule, it makes surprise inflations difficult to engineer; like discretion, it allows for extraordinary measures. Inflation targeting has proved a popular and (the authors argue) successful compromise. Many countries, including Britain and Canada, have explicitly adopted such a regime; Germany and others have done so implicitly.

The conspicuous exception is the United States: by the standards of those other central banks, the Fed's discretion is relatively unconstrained. So the puzzle remains: the Fed takes the markets by surprise and is applauded for it by most economists, despite the clear presumption in the literature that central banks should not be in a position to spring surprises. What resolves the paradox, maybe, is the enormous regard that most economists have for Alan Greenspan's judgment: this suppresses whatever reservations they might have about central-bank discretion. But it seems unwise to rely on the man rather than the system.

If the Fed were constrained by an inflation target, or by a target for growth in nominal GDP (which is similar and in some ways better), it might well have cut rates last week anyway. The difference is that it would have been obliged to explain exactly why its actions did not jeopardise the target, or why the target had been put to one side for the time being. It would be good to hear those explanations. If they were convincing, the applause the Fed has been getting might even be deserved.

"Inflation Targeting" by Ben Bernanke, Thomas Laubach, Frederic Mishkin and Adam Posen will be published shortly by Princeton University Press.

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